

Sale by an exempt vocational school of articles made by its students is a related trade or business within the meaning of section 513 of the Code, but the sale of articles made by non-students is unrelated trade or business.

The Internal Revenue Service has been asked whether under the circumstances described below the sale of handicraft articles is unrelated trade or business within the meaning of section 513 of the Internal Revenue Code of 1954.

An organization exempt from Federal income tax under section 501(c)(3) of the Code operates a handicraft school, largely devoted to teaching skills in weaving. It also operates a handicraft shop, where articles made by the students as part of their regular courses of instruction are sold. The students are paid a percentage of the sales price. In addition, the shop sells woven products made by local residents, many of whom are former students of the school. The local residents make articles at home according to the shop's specifications. The shop manager periodically inspects the articles during their manufacture to ensure that desired standards of style and quality are met. Any qualified weaver may participate in this program. The completed articles are purchased by the organization and sold in its shop.

Section 513 of the Code defines 'unrelated trade or business' as any trade or business whose conduct is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 501.

Section 1.513-1(d)(2) of the Income Tax Regulations provides that a trade or business is 'substantially related' to exempt purposes when the business activity has a substantial causal relationship to the achievement of the exempt purpose. Moreover, the conduct of trade or business from which the income is derived must contribute importantly to the accomplishment of the organization's exempt purpose. Section 1.513-1(d)(4)(ii) of the regulations provides that income from the sale of products which result from the performance of exempt functions does not constitute income from the conduct of unrelated trade or business, if the product is sold in substantially the same state it is in on completion of the exempt functions.

In this case, income from the sale of those articles made by students clearly falls within the scope of section 1.513-1(d)(4)(ii) of the regulations. Thus, the sale of these articles does not constitute unrelated trade or business under section 513 of the Code.

The sale of articles made by local residents, however, is an

activity having no causal relationship to the performance of the organization's exempt purpose; it does not contribute importantly to the accomplishment of that purpose. The articles are made independently of the performance of any instructional or other exempt function. The guidance by the shop supervisor is not education, but ordinary industrial supervision. Neither are the sales conducted in furtherance of any program to provide markets for needy individuals who are not otherwise able to support themselves, as in Revenue Ruling 68-167, C.B. 1968-1, 255. Accordingly, the sale of these products is unrelated trade or business under section 513 of the Code.